**Additional Effort Is Needed to Prevent
Taxpayers' Personal Exemptions and Tax
Credits From Being Erroneously Denied**

May 2003

Reference Number: 2003-40-124

INSPECTOR GENERAL
for TAX
ADMINISTRATION

May 30, 2003

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Effort Is Needed to Prevent
Taxpayers' Personal Exemptions and Tax Credits From Being
Erroneously Denied (Audit # 200240025)

This report presents the results of our review to determine whether the Internal
Revenue Service (IRS) accurately processed Tax Year (TY) 2001 individual income tax
returns identified as having errors with the spouse's name or Social Security Number
(SSN). In a prior audit report,[1] we found that the IRS did not always correctly resolve
these errors.

Our overall results showed that the IRS accurately resolved an estimated 91 percent[2] of
the TY 2001 tax returns filed containing a mismatch in the spouse's name or SSN.
However, despite this accuracy rate, we also determined that the IRS denied taxpayers
an estimated $34.8 million[3] in tax benefits by erroneously denying personal exemptions
and Earned Income Tax Credits (EITC) claimed on some returns.

The impact on taxpayers was estimated using statistically valid methods to sample from
523,259 individual income tax returns that the IRS had identified as having a mismatch
in either a spouse's name or SSN. The estimated $34.8 million loss in taxpayer benefits
was statistically calculated from a sample taken from 85,171 of these 523,259 returns
where the IRS had initially denied the spouses' personal exemptions and the EITC
claims during the IRS' original processing of the tax returns.

The loss of these tax benefits occurred when IRS employees did not perform adequate
research to properly resolve the mismatch identified in a spouse's name or SSN and

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[1] *The Internal Revenue Service Successfully Processed Individual Tax Returns During the 2001 Filing Season*
(Reference Number 2001-40-192, dated September 2001).
[2] See Appendix VI for details of the statistical sampling methodology.
[3] The margin of error is +/- $4.1 million. See Appendix VII for details of the statistical sampling methodology.

erroneously denied the personal exemption and EITC claims in 62 percent of the returns sampled. This condition also unnecessarily increased taxpayer burden because taxpayers had to address the subsequent IRS tax assessment notices that were sent to them. Further research of taxpayer accounts found that 50 percent of the affected taxpayers in our sample had responded to the IRS to have their tax benefits properly restored. However, the remaining 50 percent of the taxpayers who have not responded to their notice assessments represents an estimated IRS liability of $14.3 million[4] in outstanding taxpayer entitlements based on the additional tax assessments erroneously issued to these taxpayers.

We also determined that resources of $500,764 could have been more efficiently used if the IRS had updated its computer records with spouse information by assigning a Returns Processing Code (RPC) E.[5] In our sample, 76 percent of the TY 2001 returns were assigned an RPC E. The IRS had planned to review these returns during Calendar Year 2002 to determine if the spouses' personal exemptions and EITC claims were accurately processed. If the results had indicated a high accuracy rate, the IRS would have performed a one-time systemic update of the spouse information to its computer records. However, this plan was postponed because resources were needed to resolve Rate Reduction Credit errors identified on TY 2001 returns. In addition, in January 2002, the IRS eliminated a procedure that would have updated the spouse's name and SSN on its computer records if research indicated the spouse information was accurate. The IRS felt that implementing the procedure would have created capacity problems for its Error Resolution System.[6]

To decrease the burden to taxpayers who have their personal exemptions and EITC claims erroneously disallowed, we recommended the Commissioner, Wage and Investment Division, ensure the controls are strengthened to accurately resolve returns with mismatches and ensure computer records are updated with spouse information if an RPC E is assigned to the return.

<u>Management's Response</u>: IRS management appreciated our recognition that overall the IRS accurately resolved tax returns filed with a mismatch in the spouse's name or SSN, but agreed that they could further improve the reconciliation process. The IRS believes the best solution is for the taxpayer to resolve mismatches with the Social Security Administration, and began issuing "soft notices" to taxpayers whose accounts showed a mismatch condition.

While management agreed that a systemic solution that accurately updates IRS computer records would be beneficial to the processing of mismatched returns and save staff resources, they did not agree that their decision not to perform this update was an inefficient use of resources. They believe that the accuracy rate for the update of 92.5 percent would not have been acceptable for this critical process, as this would have erroneously classified approximately 30,000 taxpayer accounts as valid.

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[4] The margin of error is +/- $2.4 million. See Appendix VII for details of the statistical sampling methodology.
[5] An RPC E is assigned when the spouse's name and SSN are determined to be correct. It allows the spouse's personal exemption and EITC claim, if applicable, to process.
[6] The Error Resolution System is an IRS system that processes returns with errors.

Therefore, they believe it was a sound management decision to postpone the update until the accuracy rate increases to an acceptable level. We concur with the IRS' proposed suspension and management's assurances that they will monitor the accuracy rate and institute a systemic update when that rate attains an acceptable level. Management's complete response to the draft report is included as Appendix VIII.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

Table of Contents

**Additional Effort is Needed to Prevent Taxpayers' Personal Exemptions
and Tax Credits From Being Erroneously Denied**

Background

Generally, a taxpayer identification number refers to an individual's Social Security Number (SSN) and is considered correct when it matches the information provided by the Social Security Administration (SSA). The Small Business Job Protection Act of 1996[1] gave the Internal Revenue Service (IRS) the authority to deny the personal exemption[2] to taxpayers that fail to provide a correct taxpayer identification number. The Personal Responsibility and Work Opportunity Reconciliation Act of 1996[3] authorized the IRS to also deny the Earned Income Tax Credit (EITC)[4] to taxpayers that do not provide a correct taxpayer identification number.

In the 2001 Filing Season,[5] the IRS expanded its SSN verification process from the primary taxpayer to the spouse, also referred to as the secondary taxpayer, on jointly filed tax returns. We previously reviewed this process and estimated that 66,000 taxpayers had been erroneously denied the spouse's exemption and EITC.[6] This review was conducted to assess whether the IRS has effectively addressed this condition and reduced its reoccurrence.

We conducted the audit from June 2002 through January 2003 at the IRS' Austin Campus. The audit included TY 2001 individual income tax returns that were processed at the 10 IRS Submission Processing sites between January and May 2002, and was conducted in accordance with *Government Auditing Standards*.

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[1] Small Business Job Protection Act of 1996, Pub. L. No. 104-188, Section (§) 1615, 110 Stat. 1755, 1853-54 (1996).
[2] The personal exemption is $2,900 for Tax Year (TY) 2001.
[3] Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, § 451, 110 Stat. 2105, 2276-77 (1996).
[4] The EITC is a tax credit based on the taxpayer's earned income and family size. Taxpayers must meet a number of specific eligibility and income requirements to qualify.
[5] Filing Season refers to the period from January through mid-April when most individual income tax returns are filed.
[6] *The Internal Revenue Service Successfully Processed Individual Tax Returns During the 2001 Filing Season* (Reference Number 2001-40-192, dated September 2001).

Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Most Returns Containing a Mismatch in a Spouse's Name or Social Security Number Were Accurately Resolved

Our overall results showed that the IRS accurately resolved an estimated 91 percent[7] of the TY 2001 tax returns filed that contained a mismatch in the spouse's name or SSN. These results were estimated using statistically valid methods to sample from 523,259 individual income tax returns that the IRS had identified as having this type of mismatch.

A mismatch or error occurs when the spouse's name and SSN information does not match the IRS and SSA records. The IRS verifies this information during the processing of the return. These mismatches can occur for several reasons. For example, the spouse's name may not match IRS and SSA records because:

- The taxpayer is newly married and has not informed the SSA of a name change.

- The spouse uses an incorrect SSN on the return.

- The IRS incorrectly transcribes the spouse's name or SSN during processing.

When a return with a mismatch on the spouse's name or SSN is identified, it is forwarded to an IRS employee for resolution. If the mismatch is not the result of an IRS transcription error and if additional documentation with the return indicates the SSN is correct, the employee is instructed to accept the information on the return. If there is no additional documentation to support the information on the return, the IRS will deny the spouse's personal exemption and the EITC, if applicable.

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[7] See Appendix VI for details of the statistical sampling methodology.

**Personal Exemptions and Earned
Income Tax Credits Totaling
$34.8 Million Were Erroneously
Denied**

Despite the IRS' accuracy rate in resolving the returns with mismatches, we also determined that the IRS denied taxpayers an estimated $34.8 million[8] in tax benefits by erroneously denying personal exemptions and EITC claims on some returns.

The estimated $34.8 million loss in taxpayer benefits was calculated from a statistical sample taken from the 85,171 returns where the IRS had initially denied the spouses' personal exemptions and the EITC claims during the IRS' original processing of the tax returns. See Appendix VII for details of our statistical sampling methods, sample results, and population projections.

When the IRS determines that the spouse's name or SSN on a return is incorrect, it denies the spouse's personal exemption and EITC, if applicable, and notifies the taxpayer.[9] The tax effect for the loss of the personal exemption depends on the taxpayer's tax rate bracket. For example, if the taxpayer is in the 15 percent tax rate bracket, losing the spouse's $2,900 personal exemption amounts to $435[10] in additional tax.

The amount of the EITC a taxpayer will lose because of a mismatch in the spouse's name or SSN will vary significantly between taxpayers because the EITC is based on the taxpayer's earned income and family size. For example, married taxpayers with 2 children that meet all eligibility requirements and have earned income of $14,010 will qualify for an EITC of $3,811. Another married taxpayer with 1 child and $27,010 in earned income only qualifies for $201.

The IRS is required to perform research on the mismatches. However, while the mismatch returns are forwarded for resolution, the IRS does not always perform adequate research. The loss of these tax benefits occurred when IRS employees did not perform adequate research to properly resolve the mismatch identified in a spouse's name or SSN

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[8] The margin of error is +/- $4.1 million.
[9] Taxpayer Notice Code (TPNC) 648 is used when the spouse's personal exemption is denied. When the EITC is claimed, TPNC 701 is used to deny the spouse's personal exemption and EITC claim.
[10] Personal exemption of $2,900 times the 15 percent tax rate.

and erroneously disallowed the personal exemption and EITC claims; this happened in 62 percent of the returns sampled. This also unnecessarily increased taxpayer burden because taxpayers had to address the subsequent IRS tax assessment notices that were sent to them.

Half of the affected taxpayers in our sample did not receive $14.3 million in taxpayer entitlements

When the IRS erroneously denied the spouses' personal exemptions and EITC claims on returns in our sample, we performed an additional analysis to determine if a subsequent correction had been made. In some instances, taxpayers contacted the IRS when their personal exemption and EITC were denied. When they provided additional information, the IRS made corrections to allow the personal exemption and EITC, if applicable.

Further research of taxpayer accounts found that 50 percent of the affected taxpayers in our sample had responded to the IRS to have their tax benefits properly restored. However, we estimate that the remaining 50 percent of the taxpayers who have not responded to their assessment notices represents an estimated IRS liability of $14.3 million[11] in outstanding taxpayer entitlements based on the additional tax assessments erroneously issued to these taxpayers.

Overall, the IRS did well in accurately resolving tax returns filed with a mismatch in the spouse's name or SSN. However, we believe the conditions identified demonstrate the need for additional effort when processing personal exemptions and tax credits on individual income tax returns. These additional efforts will decrease the burden to taxpayers who have their personal exemptions and EITC claims erroneously disallowed.

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[11] The margin of error is +/- $2.4 million. See Appendix VII for details of the statistical sampling methodology.

Recommendation

1. The Commissioner, Wage and Investment (W&I) Division, should strengthen existing controls to ensure more mismatches of spouses' names and SSNs are accurately resolved.

Management's Response: The Internal Revenue Manual (IRM) 3.12.3 was revised on April 21, 2003, to provide additional and more concise procedures to resolve mismatches of spouses' names and SSNs.

Resources Could Be More Efficiently Used by Updating Computer Records With Spouse Information

When an IRS employee determines that the spouse's information is valid on a mismatch return, the employee assigns a Return Processing Code (RPC) E to the return, indicating that the spouse's name and SSN were determined to be correct. This code instructs the Error Resolution System (ERS)[12] to accept the spouse's name and SSN on the return and allow the spouse's personal exemption and EITC claim, if applicable.[13]

The IRS had planned to review TY 2001 returns assigned an RPC E during Calendar Year 2002 to determine if the spouses' personal exemptions and EITC claims were accurately processed. If the results of its review had indicated a high accuracy rate, the IRS would have performed a one-time systemic update of the spouse information to its computer records. However, this plan was postponed because resources were needed to resolve the large volume of Rate Reduction Credit errors identified on TY 2001 returns.

In addition, in January 2002, the IRS eliminated a procedure that would have updated the spouse's name and SSN on IRS computer records if research indicated the spouse information was accurate. The IRS felt that implementing this procedure would have created capacity problems for the ERS and delayed the date[14] the returns would be processed.

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[12] The ERS is an IRS system that processes returns with errors.
[13] See Appendix V (Population C) for details about these returns.
[14] Program Completion Date.

During our review, we determined that 76 percent of the TY 2001 returns in our sample were assigned an RPC E and that all of these returns were processed accurately. We also found that an RPC E was assigned to several taxpayers' TY 2000 returns that showed the same spouses' names and SSNs as reported on the TY 2001 returns. If these same taxpayers file a joint return for TY 2002, we estimate that 399,963 errors could be avoided if the IRS had gone forward with its plan to update its computer records. This would result in a potential staff year savings of $500,764 by more efficiently using existing IRS resources.

The IRS' current plan is to review a sample of TY 2001 returns[15] assigned an RPC E and perform the one-time systemic update if the sample results indicate a high accuracy rate. If a low accuracy rate is found, the IRS will revise its procedures for updating the spouse's name and SSN data to its computer records, and employees will continue to work these types of cases.

We believe that if the IRS had updated its computer records with the spouse's name and SSN information when an RPC E was assigned to the prior year return, then the TY 2001 return would not have been identified as a mismatch, as will likely be the case with many TY 2002 returns also. More importantly, the IRS would not have incurred the costs of researching the spouse's name or SSN when the return was processed.

Recommendation

2. The Commissioner, W&I Division, should ensure that an assessment of the accuracy rate for processing TY 2001 returns assigned an RPC E is completed. This assessment should include either a one-time systemic update of its computer records for the spouse's name and SSN data or a revision to the IRS procedures to ensure computer records are updated with the

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[15] The IRS has identified a population of 714,389 TY 2001 Individual Income Tax Returns (Forms 1040, 1040A, and 1040EZ) processed between February and October 2002.

spouse's name and SSN data at the time the RPC E is assigned.

Management's Response: While management agreed that a systemic solution that accurately updates IRS computer records would be beneficial to the processing of mismatched returns and save staff resources, they did not agree that their decision not to perform this update was an inefficient use of resources. They believe that the accuracy rate for the update of 92.5 percent would not have been acceptable for this critical process, as this would have erroneously classified approximately 30,000 taxpayer accounts as valid. Therefore, they believe it was a sound management decision to postpone the update until the accuracy rate increases to an acceptable level.

The IRS will perform a similar analysis of TY 2002 RPC E returns to determine the success of the IRM procedural revision and to see if the accuracy level is high enough for a systemic update. IRS management does not plan to issue procedures to update the records when the RPC E is assigned because systemic updates are more efficient and allow them to ensure the accuracy of changes to the Master File.

Auditor's Comment: We concur with the IRS' proposed suspension and management's assurances that they will monitor the accuracy rate and institute a systemic update when that rate attains an acceptable level that is in the best interest of the taxpayer and the IRS. Once this systemic update is performed, we believe resources will be used more efficiently.

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine if the Internal Revenue Service (IRS) accurately processed Tax Year (TY) 2001 individual income tax returns identified as having errors with the spouse's name or Social Security Number (SSN). The purpose of the review was to follow up on issues identified in our review of the IRS' 2001 Filing Season.[1] In that report, we estimated the IRS erroneously denied spouses' personal exemptions and Earned Income Tax Credits (EITC) totaling approximately $36.5 million for 66,000 taxpayers. To accomplish our objective, we:

I.   Determined if the IRS accurately processed TY 2001 individual income tax returns[2] identified as having spouse name or SSN mismatches.

    A. Obtained assistance from the Treasury Inspector General for Tax Administration's (TIGTA) Electronic Data Processing (EDP) Group. Identified a population of 523,259 returns with spouse name or SSN mismatches that were processed to the Individual Master File (IMF)[3] between January and May 2002.[4]

    B. Used statistical sampling methods and selected a random sample of 196 returns[5] to determine if the IRS accurately processed the returns with spouse name or SSN mismatches.

        1. Researched spouse information on IRS and Social Security Administration (SSA) computer records and researched return information posted to the IMF. Determined that the IRS accurately processed 178 (91 percent) of the 196 returns in the sample in accordance with IRS Internal Revenue Manual (IRM)[6] procedures.

        2. Based on the sample results, calculated the number of returns that were accurately processed for the population. See details of our statistical sampling methodology, sample results, and population projections in Appendix VI.

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[1] *The Internal Revenue Service Successfully Processed Individual Tax Returns During the 2001 Filing Season* (Reference Number 2001-40-192, dated September 2001).
[2] United States Individual Income Tax Returns (Forms 1040, 1040A, and 1040EZ).
[3] The IMF is the IRS database that maintains transactions or records of individual tax accounts.
[4] IRS processing cycles 200201 through 200220.
[5] See Appendix VI for details on the sampling methodology.
[6] The IRM contains the IRS' detailed operating procedures.

C. Computer analyzed the population of 523,259 returns and identified 399,963 returns that were assigned a Return Processing Code (RPC) E.[7]

D. Interviewed IRS Error Resolution System (ERS)[8] officials at one Submission Processing site about potential staff year savings associated with returns assigned an RPC E. Based on their comments, we estimated the potential staff year savings for the 399,963 returns assigned RPC E. Discussed our estimate with Submission Processing officials during the review.

II. Determined if the IRS accurately processed TY 2001 individual income tax returns that were assigned Taxpayer Notice Codes (TPNC) 648 or 701.[9]

A. Obtained assistance from the TIGTA EDP Group and identified a population of 85,171 returns assigned TPNC 648 or 701 that were processed to the IMF between January and May 2002.

B. Used statistical sampling methods and selected a random sample of 382 returns[10] to determine if the IRS accurately processed returns assigned TPNC 648 or 701.

1. Researched spouse information on IRS and SSA computer records and researched return information posted to the IMF. Determined that the IRS erroneously assigned TPNC 648 or 701 and erroneously denied the spouses' personal exemptions and EITC claims, if applicable, to 237 of the 382 returns in the sample.

2. Performed research to determine if the IRS made subsequent adjustments to correct the erroneously denied spouses' personal exemptions and EITC claims on the 237 returns identified above. Determined that 119 (50 percent) of the 237 returns were not subsequently corrected.

3. Based on the sample results, calculated the number of returns in the population that were erroneously denied spouses' personal exemptions and EITC claims and the corresponding tax dollars. Also calculated the number of returns in the population that were not subsequently corrected and the corresponding tax dollars. See details of our statistical sampling methodology, sample results, and population projections in Appendix VII.

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[7] An RPC E is assigned when the spouse's name and SSN is determined to be correct. It allows the spouse's personal exemption and EITC claim, if applicable, to process.
[8] The ERS is an IRS system that processes returns with errors.
[9] TPNC 648 is used when the spouse's personal exemption is denied. When the EITC is claimed, TPNC 701 is used to deny the spouse's personal exemption and EITC claim.
[10] See Appendix VII for details on the sampling methodology.

Major Contributors to This Report

Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Gary Young, Acting Director
Tina Parmer, Acting Audit Manager
Sharon Buford, Senior Auditor
Cari Fogle, Senior Auditor
Steve Vandigriff, Senior Auditor
Lawrence White, Senior Auditor
Glory Jampetero, Auditor
John Ojeda, Auditor
Layne Powell, Computer Specialist

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      Program/Process Assistant Coordinator, Wage and Investment Division W:HR

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 52,841 taxpayer accounts were erroneously denied the spouses' personal exemptions and Earned Income Tax Credits (EITC) totaling $34.8 million; (see page 3).

Methodology Used to Measure the Reported Benefit:

Using computer analysis, we identified a population of 85,171 Tax Year (TY) 2001 individual income tax returns processed to the Individual Master File (IMF)[1] between January and May 2002 where a Taxpayer Notice Code (TPNC) 648 or 701[2] was assigned. A statistical sample of 382[3] returns was reviewed to determine whether the Internal Revenue Service's (IRS) denials of the spouses' personal exemptions and EITC claims were appropriate. Review of the sample determined that 237 (62 percent) of the 382 returns contained erroneously denied spouses' personal exemptions and EITC claims. For these 237 returns, we found that the spouses' names or Social Security Numbers (SSN) on the returns were valid and that the IRS should have allowed the spouses' personal exemptions or EITC claims.

Based on the sample results, we statistically projected that the IRS erroneously denied the spouses' personal exemptions and EITC claims on 52,841 +/- 4,140 returns. The tax effect associated with the erroneously denied spouses' personal exemptions and EITC claims amounted to $34.8 +/- $4.1 million. See Appendix VII for details of our statistical sampling methodology, sample results, and population projections.

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[1] The IMF is the IRS database that maintains transactions or records of individual tax accounts.
[2] TPNC 648 is used when the spouse's personal exemption is denied. When the EITC is claimed, TPNC 701 is used to deny the spouse's personal exemption and EITC claim.
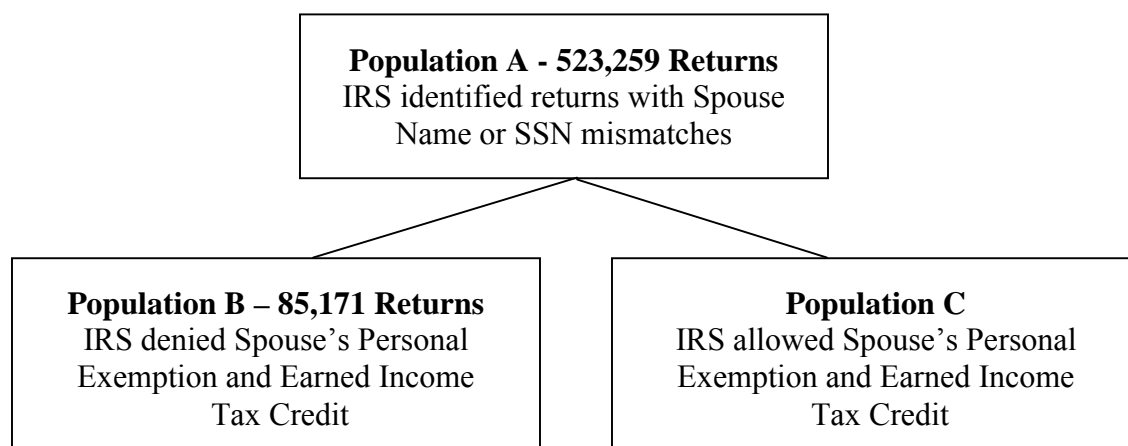[3] Sample size was computed using a 95 percent confidence level, 50 percent expected error rate, 5 percent precision, and universe of 85,171. See Appendix VII for details.

Overview of the Internal Revenue Service's Verification of Returns With
Spouse Name or Social Security Number Mismatches

This appendix presents an overview of how the Internal Revenue Service (IRS) processes returns with spouse name or Social Security Number (SSN) mismatches. It also presents detailed information on the tests we performed to determine if the IRS accurately processed these returns. The following diagram shows the three major processes and populations of returns that we tested during the review:

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                    ┌─────────────────────────────────┐
                    │  Population A - 523,259 Returns  │
                    │  IRS identified returns with Spouse │
                    │      Name or SSN mismatches      │
                    └─────────────────────────────────┘
                           ╱                    ╲
      ┌──────────────────────────────┐  ┌──────────────────────────────┐
      │  Population B – 85,171 Returns │  │        Population C          │
      │  IRS denied Spouse's Personal  │  │  IRS allowed Spouse's Personal │
      │  Exemption and Earned Income   │  │  Exemption and Earned Income  │
      │           Tax Credit           │  │          Tax Credit          │
      └──────────────────────────────┘  └──────────────────────────────┘
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Source: Treasury Inspector General for Tax Administration (TIGTA) analysis.

Population A

When a return is processed, the IRS verifies the spouse's name and SSN on the return by performing a computer match against IRS and Social Security Administration (SSA) records. A "mismatch" occurs when the spouse's name or SSN on the return does not agree with IRS or SSA records. Some examples include: 1) when a spouse marries and uses the married name on the tax return, but does not inform the SSA of the name change; 2) when the spouse uses an incorrect SSN on the return; or 3) when the IRS incorrectly transcribes the spouse's name or SSN from the return during processing.

Returns with spouse name or SSN mismatches are forwarded to the IRS' Error Resolution System (ERS)[1] for further analysis. A tax examiner reviews the return and its attachments for documentation that confirms that the spouse's name and SSN on the return are valid; for example, a Wage and Tax Statement (Form W-2), marriage license, or driver's license. The tax

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[1] The ERS is an IRS system that processes returns with errors.

examiner also verifies whether the spouse's name and SSN were transcribed correctly and researches IRS records to determine if an incorrect name or SSN was reported on the return.

Using computer analysis, we identified 523,259 Tax Year (TY) 2001 individual income tax returns with spouse name or SSN mismatches that were processed to the Individual Master File (IMF)[2] between January and May 2002 (Population A). We reviewed a statistical sample of 196 returns in the population to determine if the IRS accurately processed the returns (details of our statistical sampling methodology are presented in Appendix VI).

For each of the 196 returns, we researched the IRS and SSA computer records to determine if the spouse information on the return was valid. If the spouse information was valid, we verified that the IRS allowed the spouse's personal exemption and Earned Income Tax Credit (EITC) claim. If the spouse information was incorrect, we verified that the IRS denied the exemption and the EITC claim.

Population B

If an IRS tax examiner determines that the spouse's name or SSN on the return is incorrect, the tax examiner enters a Taxpayer Notice Code (TPNC) 648 or 701.[3] This instructs the ERS to deny the spouse's personal exemption[4] and EITC claim, if applicable, and issue a notice to the taxpayer that explains the changes made to the return. If the taxpayer subsequently contacts the IRS or SSA and provides information that resolves the mismatch, the IRS will adjust the taxpayer's account to allow the personal exemption and EITC claim, if applicable.

In a prior audit,[5] we reviewed the IRS' verification process and found that the IRS might have erroneously denied exemptions and EITC claims totaling approximately $36.5 million for 66,000 taxpayers. We performed this test to determine if the condition still exists.

Using computer analysis, we identified 85,171 TY 2001 individual income tax returns assigned a TPNC 648 or 701 that were processed to the IMF between January and May 2002 (Population B). We reviewed a statistical sample of 382 returns to determine if the IRS' denials of the spouses' personal exemptions and EITC claims were appropriate (details of our statistical sampling methodology are presented in Appendix VII).

Population C

If a tax examiner determines that the spouse's name and SSN on the return are valid, the tax examiner assigns a Return Processing Code (RPC) E[6] to the return. The RPC E instructs the

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[2] The IMF is the IRS database that maintains transactions or records of individual tax accounts.
[3] TPNC 648 is used when the spouse's personal exemption is denied. When the EITC is claimed, TPNC 701 is used to deny the spouse's personal exemption and EITC claim.
[4] The amount of the exemption was $2,900 for TY 2001 Individual Income Tax Returns.
[5] *The Internal Revenue Service Successfully Processed Individual Tax Returns During the 2001 Filing Season* (Reference Number 2001-40-192, dated September 2001).
[6] An RPC E is assigned when the spouse's name and SSN are determined to be correct. It allows the spouse's personal exemption and EITC claim, if applicable, to process.

computer to allow the spouse's personal exemption and EITC claim, if applicable. The Internal Revenue Manual[7] describes various situations for assigning an RPC E to a return. For example, an RPC E should be assigned to a return when the taxpayer provides documentation that confirms the spouse's name and SSN are correct as reported on the return. In addition, an RPC E should be assigned when IRS computer records indicate the same spouse (e.g., wife) filed a joint return with the same primary taxpayer (e.g., husband) in a prior year. Finally, an RPC E should be assigned when research of IRS or SSA computer records indicate that the spouse is using a married surname on the return, but did not notify the SSA of the name change.

When we reviewed the initial sample of returns for Population A, we found that an RPC E was assigned to 152 (78 percent) of the 196 returns in our statistical sample and that all 152 returns were accurately processed. Using computer analysis, we determined that 399,963 (76 percent) of the 523,259 returns in Population A were assigned an RPC E.

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[7] The Internal Revenue Manual contains the IRS' detailed operating procedures.

**Sampling Methodology for Tax Year 2001 Returns
With Spouse Name or Social Security Number Mismatches**

This appendix presents details of our statistical sampling methodology and sample results for Tax Year (TY) 2001 returns identified as having spouse name or Social Security Number (SSN) mismatches.[1]

Sampling Methodology

Objective
Review a statistical sample of TY 2001 individual income tax returns[2] identified as having spouse name or SSN mismatch and determine if the Internal Revenue Service (IRS) accurately processed the spouse's personal exemption and Earned Income Tax Credit (EITC) claim.

Universe/Population
Using computer analysis, we identified 523,259 returns with a spouse name or SSN mismatch that were processed to the Individual Master File (IMF)[3] between January and May 2002. These returns had a filing status of "married filing joint" with a Secondary (spouse) National Account Profile (NAP)[4] Access Indicator that was not equal to a blank.

Sampling Criteria
A sample size of 196 was determined using the following criteria:

- Population of Returns   523,259
- Confidence level   95 percent
- Expected Rate of Occurrence (error rate)   15 percent
- Precision Rate (sample reliability)   +/- 5 percent

We used a random number table and the random number generation tool in Microsoft *Excel* to randomly select the sample of 196 returns from the population.

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[1] See Appendix V, Population A for information about these returns.

[2] United States Individual Income Tax Returns (Forms 1040, 1040A, and 1040EZ).

[3] The IMF is the IRS database that maintains transactions or records of individual tax accounts.

[4] The NAP contains entity information for all taxpayers. The Secondary NAP Access Indicator signifies whether the NAP has been accessed. For example: "0" (NAP not accessed), "1" (NAP not available), "2" (account does not reside on the NAP), "9" (Taxpayer Identification Number/name mismatch at SSA [Social Security Administration]), and "X" (NAP response not received by the requesting program).

Sample Results

Our test results indicated the IRS accurately processed the spouse's personal exemption and EITC claim for 178 (91 percent) of the 196 sample returns.[5]

Population Projections

Based on the sample results, we are 95 percent confident the IRS accurately processed between 453,998 and 496,410 returns in the population. The midpoint is 475,204 returns, and the standard error at a 95 percent confidence level is +/- 21,206 returns.

Formula and Data Used for Population Projection
We used the formula $Np +/- N Z \sigma_p$ and the following data to calculate the population projection:

- N (universe or population) ---------------------------------------523,259
- n (sample size) --196
- f (fraction sampled, e.g., 196 divided by 523,259) --------- .0003745
- p (sample accuracy rate, e.g., 178 divided by 196) --------- .9081632
- Z (precision at 95 percent confidence level)---------------------- 1.96
- σ_p = (one standard error of p)
  The formula for σ_p is the square root of $[p(1-p)(1-f) / n-1]$.
- Np (estimated total number of accurate returns for the population)
- $N \sigma_p$ (one standard error of the estimated total number of accurate returns for the population)

Solutions for the formula were:

Np = 475,204 (midpoint of estimated total number of accurate returns in the population)

$N Z \sigma_p$ = 21,206 (standard error of estimated total number of accurate returns in the population at a 95 percent confidence level)

$Np +/- N Z \sigma_p$ = 453,998 to 496,410

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[5] For the remaining 18 returns, the IRS improperly denied the spouse's personal exemption and EITC claim even though the spouse's name and SSN reported on the return were valid.

Sampling Methodology for Tax Year 2001 Returns Where the Spouses' Personal Exemptions and Earned Income Tax Credits Were Denied

This appendix presents details of our sampling methodology for Tax Year 2001 returns assigned a Taxpayer Notice Code (TPNC) 648 or 701[1] to deny the spouse's personal exemption and Earned Income Tax Credit (EITC) claim.[2]

Sampling Plan

Objectives
Review a statistical sample of TY 2001 individual income tax returns assigned a TPNC 648 or 701 and determine if the Internal Revenue Service's (IRS) denials of the spouse's personal exemption or EITC claim were appropriate. For each return where the spouse's personal exemption or EITC claim was erroneously denied, determine if the IRS made a subsequent adjustment to correct the taxpayer's account.

Universe/Population
Using computer analysis, we identified 85,171 TY 2001 individual income tax returns that were processed to the Individual Master File (IMF)[3] between January and May 2002 where a TPNC 648 or 701 was assigned.

Sampling Criteria
A sample size of 382 was determined using the following criteria:

- Population of Returns   85,171
- Confidence level   95 percent
- Expected Rate of Occurrence (error rate)   50 percent
- Precision Rate (sample reliability)   +/- 5 percent

We initially used an expected error rate of 15 percent and computed a sample size of 195. However, during our review of the sample returns, we periodically computed the actual error rate and found that it was greater than 50 percent. As a result, we increased the expected error rate to 50 percent and recomputed the sample size of 382.

We used a random number table and the random number generation tool in Microsoft *Excel* to randomly select the sample of 382 returns from the population.

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[1] TPNC 648 is used when the spouse's personal exemption is denied. When the EITC is claimed, TPNC 701 is used to deny the spouse's personal exemption and EITC claim.
[2] See Appendix V, Population B for information about these returns.
[3] The IMF is the IRS database that maintains transactions or records of individual tax accounts.

Sample Results

Our test results indicated the IRS erroneously assigned TPNC 648 or 701 to 237 (62 percent) of the 382 returns in the sample. The spouses' personal exemptions and EITC claims, if applicable, were erroneously denied on the 237 returns.

The IRS subsequently corrected 118 (50 percent) of the 237 returns with erroneously denied spouses' personal exemptions and EITC claims. However, we determined that no subsequent adjustments were made to 119 (50 percent) of the 237 returns to correct those erroneously denied spouses' personal exemptions and EITC claims.

Population Projections

Based on the sample results, we are 95 percent confident that the IRS erroneously denied the spouses' personal exemptions and EITC claims on 48,701 to 56,981 returns in the population. The midpoint is 52,841 returns, and the standard error at a 95 percent confidence level is +/- 4,140 returns. The tax effect associated with the erroneous disallowances is between $30.7 and $38.9 million. The midpoint is $34.8 million, and the standard error at a 95 percent confidence level is +/- $4.1 million. The tax dollars reflect IRS changes to spouses' exemptions and EITC claims only. We did not consider other IRS adjustments that affected the tax dollars.

Furthermore, we are 95 percent confident that the IRS has not made subsequent adjustments on 22,581 to 30,483 returns, to allow spouses' exemptions and EITC claims that were erroneously denied. The midpoint is 26,532 returns, and the standard error at a 95 percent confidence level is +/- 3,951 returns. The tax dollars that have not been adjusted and credited to taxpayers' accounts range from $11.9 to $16.7 million. The midpoint is $14.3 million, and the standard error at a 95 per cent confidence level is +/- $2.4 million.

Formulas and Data Used for Population Projections
We used the formula Np +/- $N Z \sigma_p$ and the following data to calculate the population projection of "48,701 to 56,981 returns:"

- N (universe or population) -- 85,171
- n (sample size) -- 382
- f (fraction sampled, e.g., 382 divided by 85,171)-------------- .004485
- p (sample accuracy rate, e.g., 237 divided by 382) ---------- .6204188
- Z (precision at 95 percent confidence level)----------------------- 1.96
- σ_p = (one standard error of p)
  The formula for σ_p is the square root of [p(1-p)(1-f) / n-1].
- Np (estimated total number of error returns for the population)
- N σ_p (one standard error of the estimated total number of error returns for the population)

Solutions for the formula were:

Np = 52,841 (midpoint of estimated total number of error returns in the population)

$N Z \sigma_p$ = 4,140 (standard error of estimated total number of error returns in the population at a 95 percent confidence level)

Np +/- $N Z \sigma_p$ = 48,701 to 56,981

We used the formula $N*ybar$ +/- $Z*N*[s/sqrt(n)]*sqrt(1 - f)$ and data below to calculate the population projection of "$30.7 to $38.9 million" tax dollars:

- N (universe or population) -- 85,171
- n (sample size) --- 382
- f (fraction sampled, e.g., 382 divided by 85,171)-------------------------------.004485
- ybar (average of error dollars from the sample)---------------------------------$408.27
  If the case was properly processed, the error dollars for the case is 0.
- s (sample standard deviation of error dollars for one standard deviation)
  The formula for s is the square root of [sum of $(Y – Ybar)$ squared / $(n-1)$].
- Z (reliability coefficient at 95 percent confidence level) ------------------------- 1.96

Solutions for the formula were:

$N*ybar$ = $34.8 million (estimated total error)

$Z*N*[s/sqrt(n)]*sqrt(1 - f)$ = $4.1 million (precision)

$N*ybar$ +/- $Z*N*[s/sqrt(n)]*sqrt(1 – f)$ = $30.7 to $38.9 million

We used the formula Np +/- $N Z \sigma_p$ and the following data to calculate the population projection of "22,581 to 30,483 returns:"

- N (universe or population) -- 85,171
- n (sample size) ---382
- f (fraction sampled, e.g., 382 divided by 85,171)--------------.004485
- p (sample accuracy rate, e.g., 119 divided by 382) --------- .3115183
- Z (precision at 95 percent confidence level)---------------------- 1.96
- σ_p = (one standard error of p)
  The formula for σ_p is the square root of $[p(1-p)(1-f) / n-1]$.
- Np (estimated total number of error returns for the population)
- $N \sigma_p$ (one standard error of the estimated total number of error returns for the population)

Solutions for the formula were:

Np = 26,532 (midpoint of estimated total number of error returns in the population)

$N Z \sigma_p$ = 3,951 (standard error of estimated total number of error returns in the population at a 95 percent confidence level)

Np +/- $N Z \sigma_p$ = 22,581 to 30,483

We used the formula N*ybar +/- Z*N*[s/sqrt(n)]*sqrt(1 - f) and data below to calculate the population projection of "$11.9 to $16.7 million" tax dollars:

- N (universe or population) --- 85,171
- n (sample size) --- 382
- f (fraction sampled, e.g., 382 divided by 85,171)------------------------------.004485
- ybar (average of error dollars from the sample)---------------------------------$168.38
  If the case was properly processed, the error dollars for the case is 0.
- s (sample standard deviation of error dollars for one standard deviation)
  The formula for s is the square root of [sum of (Y – Ybar) squared / (n-1)].
- Z (reliability coefficient at 95 percent confidence level) -------------------------- 1.96

Solutions for the formula were:

N*ybar = $14.3 million (estimated total error)

Z*N*[s/sqrt(n)]*sqrt(1 - f) = $2.4 million (precision)

N*ybar +/- Z*N*[s/sqrt(n)]*sqrt(1 – f) = $11.9 to $16.7 million
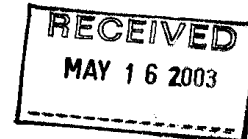
Management's Response to the Draft Report

COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

MAY 1 6 2003

RECEIVED
MAY 1 6 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM: John M. Dalrymple
             Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Additional Effort Is Needed to Prevent
             Taxpayers' Personal Exemptions and Tax Credits From Being
             Erroneously Denied (Audit No. 200240025)

I appreciate your recognition that overall the IRS accurately resolved tax returns filed
with a mismatch in the spouse's name or Social Security Number (SSN). As a result of
the effectiveness of our internal processes, we reconciled 91 percent of the returns that
had mismatch errors without burdening those taxpayers. By successfully resolving this
high percentage of invalid conditions, we timely processed approximately $352 million
in entitlements and benefits that were legally at risk due to the mismatch condition. We
agree that we could further improve the process of reconciling the incorrect SSN and
name matches.

The best solution for the taxpayer, IRS, and Social Security Administration (SSA) is for
the taxpayer to correct the mismatch condition with the SSA. This action helps assure
the taxpayer that critical data maintained by the SSA and used by many Federal and
state agencies to determine coverage, entitlements, and eligibility for benefits and
programs is accurate.

We began to stress the importance of this action by sending a "soft notice" to taxpayers
whose accounts showed a mismatch condition. The "soft notice" encouraged taxpayers
to contact the SSA to make corrections to their records. We also modified the Form
1040 Instruction Packages by including statements such as, "An incorrect or missing
SSN may increase your tax or reduce your refund." The tax packages provide
instructions on how taxpayers can correct mismatched conditions, including the toll free
telephone number for the SSA.

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We know that some taxpayers will make mistakes when providing their names and SSNs on their tax returns. We continue to take a proactive approach to reduce taxpayer burden caused by these errors when possible. Our correction procedures, research instructions, and computer programming allow us to match data and temporarily bypass the invalid condition. These processes demonstrate our commitment to minimizing the negative impact on the taxpayer and comply with the intent of the law. Your recommendations will help improve this correction process.

I agree with the methodology you used to measure the additional entitlements of $34.8 million we initially denied when we did not correct the mismatch during processing. Although we did not accurately correct all the mismatched conditions, we promptly corrected those accounts when the taxpayers responded to our notification letters advising them of the disallowance. We agree that we initially denied their entitlement; however, we reinstated it after the taxpayers contacted us and we resolved the mismatched condition. As your report reflects, these taxpayers received the benefit when we corrected the error condition.

We agree a systemic solution that accurately updates our Master File would be beneficial to the processing of mismatched returns and would save staff resources. I agree with the methodology you used to measure the potential staff year savings of $500,764 if we had performed a systemic update for the TY 2001 accounts that contained sufficient evidence to allow the exemption even though the taxpayer supplied information and the SSA data did not match.

I do not agree with the determination that our decision not to perform this systemic update for the accounts was an inefficient use of resources. Our study of the verification process revealed an accuracy rate of 92.5 percent. This is not an acceptable level of accuracy for this critical process. The suggested systemic update would have erroneously classified approximately 30,000 taxpayer accounts as "IRS valid" on the Master File. Each year, without further questioning, these erroneously classified accounts would be accepted as valid. If we accept 92.5 percent as a valid threshold, we would continue the systemic update and compound the problem by erroneously making a similar number of new accounts "IRS valid" year after year.

We made a sound management decision to suspend a systemic update until the accuracy rate for resolving the mismatched accounts increases to an acceptable level. A high level of accuracy is critical due to the impact it has on other components of the tax return, such as claimed Earned Income Tax Credits. We will institute a systemic solution when we are satisfied that the accuracy of the corrections meet a standard that is in the best interest of the taxpayer and the IRS.

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If you have any questions, please call me or Ronald S. Rhodes, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

RECOMMENDATION 1
The Commissioner, Wage and Investment (W&I) Division, should strengthen existing controls to ensure more mismatches of spouses' names and SSNs are accurately resolved.

CORRECTIVE ACTION
I agree with this recommendation. The Internal Revenue Manual (IRM) 3.12.3 was revised on April 21, 2003, to provide additional and more concise procedures to resolve mismatches of spouses' names and SSNs.

IMPLEMENTATION DATE
Completed - April 21, 2003

RESPONSIBLE OFFICIALS
Director, Submission Processing
Director, Customer Account Services

RECOMMENDATION 2
The Commissioner, W&I Division, should ensure that an assessment of the accuracy rate for processing TY 2001 returns assigned a Return Processing Code (RPC) E is completed. This assessment should include either a one-time systemic update of its computer records for the spouse's name and SSN data or a revision to the IRS procedures to ensure computer records are updated with the spouse's name and SSN data at the time the RPC E is assigned.

CORRECTIVE ACTION
I do not agree with this recommendation. We completed an assessment of the accuracy rate for processing TY 2001 returns assigned a RPC E, which indicates we temporarily bypassed the mismatch. The assessment considered the systemic update as well as the manual process to update the IRS records. In June 2002, a Request for Information Services (RIS) was submitted to request an extract of tax returns containing RPC E. We received the information in November 2002. To determine the accuracy of the RPC E, we sent approximately 350 sample cases to the Entity Function in 6 of the W&I Submission Processing campuses for review. The results of the review indicated an accuracy rate of 92.5 percent. This accuracy rate shows that the tax examiners do a "good" job in the assignment of RPC E, but it is not high enough to allow an update to the Master File records either during input or systemically. Because this update will make a name and/or SSN valid on IRS Master File, our accuracy should be close to 97 percent before a manual or systemic update is conducted.

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We submitted another RIS for a similar extract of TY 2002 RPC E returns to determine the success of the IRM procedural revision and to see if the accuracy level is high enough for a systemic update. We will make this decision in early December. We do not plan to issue procedures to update the records when the RPC E is assigned because systemic updates are more efficient and allow us to ensure the accuracy of changes to the Master File.

IMPLEMENTATION DATE
Not Applicable

RESPONSIBLE OFFICIALS
Director, Submission Processing
Director, Customer Account Services